

**Coherence for Development: Economic  
Recommendations for Spain**

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Working Paper (WP) 14/2006

3/8/2006



## Coherence for Development: Economic Recommendations for Spain<sup>1</sup>

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**Summary:** This paper looks at the coherence of development policies with regard to the consistency between, on the one hand, the objectives or results of a donor's economic policies that have an impact on the countries receiving development aid, and, on the other, the objectives of the official international development cooperation policy.

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<sup>1</sup> This working paper summarises the content of *Informes Elcano* nr 5, an Elcano report that is the result of joint work by a group of academics, civil society representatives and the business sector and members of the Spanish Administration. The authors of this working paper and report coordinators accept full responsibility for its contents. Contributors to the project do not necessarily assume responsibility, either collectively or individually.

## List of Acronyms

|         |  |
|---------|--|
| AECI    | <i>Agencia Española de Cooperación Internacional</i> (Spanish International Cooperation Agency)  |
| AGE     | <i>Administración General del Estado</i> (State General Administration)  |
| ASCM    | Agreement on Subsidies and Countervailing Measures   |
| CAP     | Common Agricultural Policy   |
| CCL     | Contingent Credit Lines  |
| CDI     | Commitment to Development Index  |
| CECO    | <i>Centro de Estudios Comerciales</i> (Centre for Commercial Studies)  |
| CESCE   | <i>Compañía Española de Crédito a la Exportación</i>   |
| CFF     | Compensatory Financing Facility  |
| CGD     | Center for Global Development  |
| DAC     | Development Assistance Committee, OECD   |
| DG DEV  | Directorate-General for Development (of the European Commission)   |
| DGPOLDE | <i>Dirección General de Planificación y Evaluación de Políticas para el Desarrollo</i> (Spanish Directorate-General of Policy Planning and Evaluation for Development) |
| EU      | European Union   |
| FDI     | Foreign Direct Investment  |
| FIEX    | <i>Fondos de Inversión en el Exterior</i> (Foreign Investment Funds)   |
| FONPYME | <i>Fondo de Inversión para la Pequeña y Mediana Empresa</i> (Investment Fund for SMEs)   |
| GATS    | General Agreement on Trade in Services   |
| GFCF    | Gross Fixed Capital Formation  |
| HIPC    | Heavily Indebted Poor Countries  |
| ICEX    | <i>Instituto Español de Comercio Exterior</i> (Spanish Institute for Foreign Trade)  |
| ICO     | <i>Instituto de Crédito Oficial</i> (Spanish Official Credit Institute)  |
| IFA     | International Financial Architecture   |
| ILLR    | International Lender of Last Resort  |
| IMF     | International Monetary Fund  |
| MAEC    | <i>Ministerio de Asuntos Exteriores y de Cooperación</i> (Ministry of Foreign Affairs and Cooperation)   |
| MDGs    | Millennium Development Goals   |
| MIGA    | Multilateral Investment Guarantee Agency   |
| NGO     | Non-Governmental Organisation  |
| NIFA    | New International Financial Architecture   |
| OECD    | Organization for Economic Cooperation and Development  |
| PRGF    | Poverty Reduction and Growth Facility  |
| SDRM    | Sovereign Debt Restructuring Mechanism   |
| SDRs    | Special Drawing Rights   |
| SMEs    | Small and Medium Enterprises   |
| SRF     | Supplemental Reserve Facility  |
| TRIMS   | Trade-Related Investment Measures  |
| TRIPS   | Trade-Related Aspects of Intellectual Property Rights  |
| UNCTAD  | United Nations Conference on Trade and Development   |
| WAIPA   | World Association of Investment Promotion Agencies   |
| WTO     | World Trade Organisation   |

## **Introduction**

This paper looks at the coherence of development policies with regard to the consistency between, on the one hand, the objectives or results of a donor's economic policies that have an impact on the countries receiving development aid, and, on the other, the objectives of the official international development cooperation policy.

We have attempted to include all the economic policies that can have an impact on aid-receiving countries. Therefore, reference is made to policies connected with trade flows, emigrant remittances, foreign direct investment (FDI) and the developing countries' external debt management, as well as international financial architecture (IFA). They are all different kinds of policies, involving different levels of public intervention, and they are organised by different levels of the Administration.

By going back to the classifications used in the specialised literature on the subject, this study covers –in a manner restricted to certain economic policies and, therefore, excluding other non-economic policies, such as security, defence and cultural policies– what the OECD (2000) has called horizontal coherence and Picciotto (2005a and b) intra-country coherence or whole of government. In the terms put forward by Forster and Stokke (1999) and Stokke (2003), this covers both the policy coherence of a specific donor country and the coherence of all industrialised countries with effects on the South. This study deals with both aspects, international and domestic, as identified by Pomfret (2005).

In other words, we exclude both the analysis of other (non-economic) foreign policies with an impact on the development of development-aid-receiving countries, and the coherence between the instruments and objectives of international development cooperation policy. Some of these aspects are covered in previous papers on the coherence of Spain's development policies, such as Alonso and FitzGerald (2003).

Very broadly speaking, the development of aid-receiving countries has been established as the objective we have to be consistent with. Taking into account that this study's ultimate aim is to guide the Spanish Administration in its policies towards developing countries, we are considering development as it is defined in current international development cooperation law –in other words, as poverty reduction– and, more precisely, in the Spanish Cooperation Master Plan 2005-2008 (MAEC, 2005). The latter includes development as it is understood in the Millennium Declaration, which leads to the Millennium Development Goals (MDGs) –the universally accepted international framework–.

The selection of policies, international flows and, in short, the variables considered in this paper is explained by the unequal growth of the various economic flows since the beginning of the eighties, which has relegated development aid to the last place in the importance of economic relations between rich and poor countries.

In this context, it is reasonable for a comprehensive review of the socio-economic development of aid-receiving countries to go hand in hand with an analysis of the impact of trade and financial flows (including emigrant remittances among the latter) and, therefore, of the policies sustaining them.

Besides the possible consequences for developing countries, there are different incentives so that donors can deal with the incoherence of existing policies. Specialised literature mentions different factors that can be grouped in two ways: first, the need to improve the efficiency of public policies in order to maintain the legitimacy of the governments that apply them and, secondly, new challenges raised by globalisation,

which has increased the interdependence between developed and developing countries.<sup>2</sup> As the OECD states (1996), the need for more policy coherence is partly due to the expansion of the interests of donor countries in the context of globalisation.

An exhaustive list of all the measures required to limit incoherencies and promote possible synergies among the different policies is, however, beyond the scope of this work and would obviously need a more complete and detailed analysis of each and every tool the State has at its disposal. As a result, the recommendations given in the second section are not exhaustive and should be considered merely as a guideline.

One of this study's aims is to show the large number of variables that have an influence on the socio-economic development of aid recipients. Furthermore, these are variables that donor governments can do something about (to a greater or lesser extent). There are also multiple connections between these variables, so specifying the factors that ultimately have an influence on achieving the MDGs is extremely complex. Consequently, we aim to contribute to overcoming the more traditional view of international cooperation that this policy –and the implicit flow of aid– has had as a sealed compartment isolated from other policies and economic relations, which also affect economic and social development. Our aim is to focus on a more comprehensive and strategic view of development.

This study also aims to offer a more complete view of the many necessary measures to achieve global and coherent actions from donor countries. However, it must be pointed out that just as the choice of measures contained in the MDGs can be arbitrary, so can the selection of variables and economic policies included in this document. Indeed, not only are we putting to one side some important dimensions of the donors' foreign action (security and defence policy and foreign cultural action), but also, as we are only dealing with the economic dimension, we have omitted other important aspects such as the impact of tax havens on developing countries' foreign financing possibilities and the effects of developed countries' fishing policies on attaining the MDGs worldwide.

These aspects should be considered in more detailed studies on policy coherence, whether geographical –country-by-country or region-by-region coherence– or sectoral –separate studies on each economic or policy aspect–.

## **1. ANALYSIS: THE IMPACT OF DONORS' POLICIES ON THE DEVELOPMENT OF AID-RECEIVING COUNTRIES<sup>3</sup>**

In this section, and based on the study group's prior studies, we shall attempt to summarise the main mechanisms by which different international economic flows (trade, remittances, direct investment and debt) and IFA can contribute to more development in aid-receiving countries. Moreover, the risks for development and poverty reduction will be identified for each variable and the main challenges the donor community faces will be summarised.

### **1.1. Trade Policy**

First, as far as trade is concerned, in principle, and in line with classic international trade theories, production specialisation allows –and is also consolidated by– an increase in the

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<sup>2</sup> Ashoff (2005), Forster and Stokke (1999), GDI (2002), Hydén (1999), Picciotto (2005a and b), Stokke (2003), Weston and Pierre-Antoine (2003).

<sup>3</sup> Unless otherwise specified, the ideas stated in this section are taken from the study group's contributions on policy coherence collected in Olivié and Sorroza (2006).

exports of certain goods and a parallel rise in imports, capital goods for the manufacture of export goods and other domestic consumer goods. All this would generate an improvement in the allocation of resources which would ultimately have an impact on economic growth.

Broadly speaking, as pointed out by Steinberg, the economic performance of developing countries in recent decades has shown that a number of features should be present for trade liberalisation to lead to economic growth.

#### *1.1.1. Strategic Trade Integration*

This is a wide-ranging and ambiguous condition, which actually refers to the need to retain some scope for manoeuvre, or policy space, so that every developing country can choose the most appropriate international trade integration policy or strategy on the basis of its social and economic characteristics and its historical evolution.

These characteristics will therefore condition the rhythm, scope and phases of trade liberalisation. As highlighted by Steinberg, a trade liberalisation policy should also be seen (by partners, donors and multilateral organisations) as part of a more extensive economic development process and strategy.<sup>4</sup> Hence, development is understood as a process of trial and error in which each society follows its own course towards liberalisation.

Although the promotion of this policy space has to form part of bilateral and regional trade agreements, it essentially includes a change in the operating mechanisms of the World Trade Organisation (WTO).<sup>5</sup> And, despite the fact that the WTO usually presents itself as an example of multilateral democratic governability (in the organisation every member State has a vote, a system absent in other bodies such as the International Monetary Fund –IMF– and the World Bank), several authors have identified deficiencies in this respect. These could be resolved, for example, by reviewing the ‘green room’ procedure, which enables agreements to be closed after negotiations that do not always include some of the countries affected. There have also been several proposals to reformulate the special and differentiated treatment to enable developing countries to be exempt from some of the regulations included in the WTO’s regulatory framework. Some denounce the limited possibilities for this type of country to make use of this special treatment. A greater promotion of policy space would therefore involve extending this mechanism, which allows a certain degree of asymmetry in the speed and scope of trade liberalisation.

#### *1.1.2. Access to Developed Countries’ Markets*

Indeed, trade liberalisation will not generate an increase in exports from the developing countries if their exports cannot be sold in the main consumer markets, such as those of OECD member countries. Therefore, the economic development of aid-receiving countries through an increase in their trade relations necessarily implies the disappearance of barriers to the donor countries’ markets.

Access to markets is mainly debated multilaterally within the WTO, whose most recent moves have been made in the framework of the Doha Round, also known as the Development Round, which started in Qatar in 2001 and will probably remain open until 2007. With regard to the different estimates included in Steinberg’s work, the most

<sup>4</sup> The importance of ownership is included in the principles of the so-called new aid architecture, as it forms part of the Comprehensive Development Framework promoted by the World Bank.

<sup>5</sup> According to the same author, the preservation or guarantee of policy space also implies the exclusion from the international trade agenda of the controversial Singapore issues. This study has not included an analysis of their pros and cons for developed and developing countries, as they have been finally excluded, for the moment, besides trade facilitation, from the Doha Round negotiations.

conservative, which exclude the liberalisation of the services sector, predict that the profits for the world economy of full access to all markets, both those of rich countries and developing countries for all types of products, would total US\$254 billion per year in constant 1995 dollars. Of this amount, US\$108,000 million would go to the developing countries and the rest of the net profits to the developed countries.

In recent years, although slowly, steps have been taken towards a greater liberalisation of the agricultural markets. However, agriculture still accounts for 66% of the protectionism in the trade for goods and services today. This explains, at least in part, its small impact on international trade, since it only represents 4% of the gross world product (World Bank, 2006). For EU member countries, agricultural protectionism derives from the CAP (Common Agricultural Policy).

A thorough reform of the CAP would lead to losses in certain sectors, as we will see in the recommendations section. Nevertheless, other collectivities should also be taken into account, particularly European consumers. According to the above-mentioned calculations, more than three quarters of the profits from liberalisation would go to the developed countries –more than US\$50 billion year in 1995 terms–.

Using the same type of estimate, the full trade liberalisation of manufactured goods would lead to earnings of around US\$96 billion per year for the developing countries, ie, 48% of total profits. Although significant headway has already been made in the trade liberalisation of manufactured products, potential profits are still important. However, most earnings derive from trade liberalisation between the developing countries themselves. According to Steinberg, there are, therefore, no significant barriers left to remove for the developing countries' manufactured goods to gain access to the developed countries' markets. Nevertheless, some of the latter continue to resort to protectionist practices and on occasion they breach current agreements. For the developing countries, the problem is heightened when the developed countries resort to these practices, since they are the world's main consumer markets.

The liberalisation of the services sector has been a controversial and much debated issue in the WTO. As we know, the developed countries are the main suppliers of services, although the developing countries are starting to shift towards a service-sector economy. According to data from Stiglitz and Charlton (2005), trade liberalisation of services would generate profits of US\$375 billion per year, in other words 75% of a full liberalisation of goods and services. In addition, 75% of the profits from service trade liberalisation would go to the developed countries. This explains the latter's strong pressure, on the one hand, and the developing countries' reluctance, on the other, to make progress in the multilateral liberalisation of the services trade.

The WTO agreement on services (General Agreement on Trade in Services –GATS–) differentiates four service provision modes. Mode 4 of GATS, which refers to the temporary transfer of workers to supply a service, is the one that offers more potential advantages to aid-receiving countries. According to data gathered by Steinberg, this profit could amount to US\$80 billion per year for all developing countries, furthermore without having to bear any additional cost. In addition, the liberalisation of mode 4 would further the flow of remittances, even if only temporarily, from the developed countries to the developing countries, so the impact on the latter's welfare could, in principle, double.

### *1.1.3. Export and Production Capacity*

Fewer trade barriers, in themselves, do not guarantee an increase in commercial activity with its subsequent benefits for the development of aid-receiving countries, as shown by the results of several trade agreements between developed and developing countries. In

many of these cases, such as the Cotonou agreement between the EU and several sub-Saharan countries, the removal of trade barriers has indeed led to an increase in trade relations between the two groups of countries; nevertheless, this has resulted in a considerably larger increase in exports from the former than in imports from the latter, which is explained by the very different export capacities of both groups of countries (see, for example, Marín, 2005). The net result has therefore been, in most cases, a deterioration of the trade balance of the developing countries, with the consequent effects on growth and socio-economic development. In other words, the production and export capacities of developing countries need to be fostered if the lowering of trade barriers is to lead to more trading activity.

#### *1.1.4. From Growth to Development*

Experience seems to demonstrate that trade liberalisation and an increase in foreign trade do enable a better allocation of resources and more economic growth. Nevertheless, for that growth also to lead to more development, understood as poverty reduction in its different aspects, according to Steinberg there have to be additional conditions. Many of them are concerned with the existence of a national development strategy that facilitates a pro-poor distribution of growth. In this case, it would involve the transfer of income to the losing sectors in trade liberalisation, although other circumstances are connected with foreign trade integration. Therefore, production diversification or technological growth would also be key factors for trade activity that promotes economic growth to also lead to higher levels of development.

### **1.2. Emigrant Remittances**

The IFA, analysed in section 1.5, partly determines what Molina calls the propensity to remit, one of the factors explaining the volume of remittances and, therefore, their impact on development.

Remittances have a possible countercyclical effect, which means that they increase at times of crisis in the destination country, although their volume and frequency are relatively independent of the issuing country's cycle. Furthermore, remittances have a direct and positive impact on income, which leads to an increase in consumption, an increase in investment or both. A great deal of literature about remittances and their impact on development focuses on their distribution between consumption and investment, as this is a central element when quantifying their net impact on development. In principle, an increase in investment would seem to be more beneficial than more consumption. Nevertheless, this will also depend, on the one hand, on whether the investment is made in productive activities or with effects on development itself, or whether, in contrast, it fuels unproductive sectors whose growth is not reflected in the country's standards of living. On the other hand, the effect will also be different depending on the type of goods consumed. If basic commodities, such as food, clothing or shoes, predominate, this will have a direct effect on the population's standards of education and health, and even diet. This leads to a positive and direct impact on the MDGs, with another indirect impact deriving from the productivity of the labour factor and its corresponding effect on economic growth.

Therefore, it can be said that remittances, besides contributing to increasing available household income, will have a wider-ranging impact on a country's development if they are used to acquire basic commodities –or those connected with the productivity of human capital– and to invest in productive sectors.

The degree to which remittances are temporary also affects how they are used at destination. Indeed, according to Molina, there is a lower tendency to consume income



that is considered temporary than if it is permanent. If the migrants' families think the flow is temporary, the propensity to invest will be greater.

As with foreign trade, for remittances to turn more economic growth into effective development and poverty reduction, they have to be included in the government's macroeconomic programme. In this respect, measures to promote the development of the financial markets that facilitate higher investment levels have to be established.

Certain mechanisms have been identified by which remittances might not have beneficial effects on development or might even become counterproductive. First, remittances can lead to higher levels of imbalance in countries that are already suffering from an unequal distribution of income. This happens when migratory movements are highly concentrated in areas and socio-economic groups that, furthermore, are not the most vulnerable in the country. As it is the migrants' families that receive the remittances, this concentration phenomenon becomes more intense. Secondly, some studies also alert to the risk of 'Dutch disease' when the volume of remittances is very high. 'Dutch disease' occurs when high currency inflows, in this case from remittances, cause the local currency to appreciate, thus undermining the country's external competitiveness –in other words, the country's export capacity–, thereby reducing the possible benefits of strategic foreign trade integration.

As this is the theoretical framework that explains the connections between emigrant remittances and development, we will now outline the main challenges facing the Administrations of both donor and developing countries.

#### *1.2.1. Uncertainty and Lack of Information*

One of the main problems when analysing the impact of remittances on development is the lack of full and reliable information on the volume, destination and use of this economic flow. The lack of information also limits the proposals for action that can be made by the Public Administration.

Hence, we should start by improving data collection systems on remittances. On the one hand, we need to have a more precise image of the proportion of their savings that immigrants are sending to their countries of origin and analyse the factors that influence the frequency and volume of these remittances, in other words, the propensity to remit. This task is, to a great extent, the responsibility of the developed countries.

On the other hand, it is essential to know which activities these savings are used for, once they are received by the migrants' families. The most likely result is that there is no single pattern of remittance sending and usage. Each country, or even each province or small community, will probably follow a specific pattern depending on a long list of factors including their real possibilities of investment, their consumption requirements, the educational and health situation in the region, the development of the financial system, the exchange rate regime, etc. In other words, broadly speaking, the use at destination of the remittances will depend on the economic and social structure of the migrant's country of origin. Case studies could throw some light on the destination of remittances and, therefore, the scope for manoeuvre of the donors' governments in this specific area.

#### *1.2.2. Sending Remittances: Security and Cost*

For remittances to contribute to the development of the recipient countries, the first condition that has to be met, obviously, is that the largest possible amount should be for the migrants and/or their families at the least possible cost.

As is well known, a large part of the remittances is channelled via the informal financial system through money transfer companies. So far, the access of migrants and their families to the formal financial system has been very limited due, in part, to the fact that a large proportion of the remittance senders are in an irregular situation in the developed countries. Cost and insecurity are usually pointed out as the main disadvantages to transferring remittances via the informal system. As far as cost is concerned, there are many different estimates: according to data collected by Atienza it could be between 10% and 20% of the amount transferred. In a study published by CECA (2002), money transfer costs in Spain are shown to be considerably lower than in other countries, at less than 10% of the amount transferred.

### *1.2.3. Use at Destination: Consumption versus Investment*

A donor country's scope for manoeuvre as regards the use at destination of remittances is very limited, since it depends on several factors, which are, in the main, not under the donors' control.

First, as Atienza points out, the lack of empirical evidence available for Latin America shows that remittances are used more for consumption than for investment. Specifically, according to a study by IADB/MIF (2004), between 61% and 74% of the flows are used for basic commodities, which improve the standard of living through food and healthcare. In turn, non-basic consumption, which is more marginal, takes up between 3% and 17% of the remittances received. Investment, on the other hand, is absorbing only between 1% and 8% of the remittances. In addition, the bulk of investment is made in the housing and construction sector while investment in production, which would guarantee a greater impact on development, is irrelevant. However, if investments in housing and construction manage to considerably improve the basic living conditions of migrants' families, who start off with very deficient living standards, then the remittances would be contributing to covering basic social needs, just as consuming basic commodities does. In that case, this would be a very direct contribution to fulfilling the MDGs and, specifically, the seventh goal. The latter will depend on various factors, including the welfare level the migrants' families start off with. Yet again, information and its analysis have to be improved in order to conclude if this transfer method is growing. In any event, as mentioned above, the investment and consumption pattern is probably not the same for all the destination countries and communities of the remittances.

In principle, use at destination would appear to facilitate the impact of remittances on a country's socio-economic development by means of basic consumption and perhaps an improvement in living conditions. Nevertheless, there appears to be an insufficient channelling of remittances towards production investments, which would potentially have a greater macroeconomic impact.

This problem should be tackled by analysing and identifying a donor's scope for manoeuvre in the factors that determine the use at destination of the remittances and, in particular, its possibilities for production investment. In this respect, Atienza has identified a series of factors that could be summarised as:

- Low bank usage, the consequence of underdevelopment of the local financial system and the lack of legitimacy in the sector. This not only explains why the investment of remittances is low, but also determines the low proportion of remittances that are transferred via formal channels.
- A not very favourable investment climate, connected with a certain institutional weakness.

- The small size of the market, and, therefore, fewer investment possibilities.
- Regular sending of remittances. They are perceived, therefore, as ordinary income used to cover the family's daily expenses, and not as extraordinary and temporary income that can be saved or invested productively.

### **1.3. Foreign Direct Investment and Development**

This type of foreign capital has been traditionally recognised as one of the most benign for development, above all when compared with portfolio investment, financial derivatives or different forms of debt. This emphasis on the advantages of FDI increased as a result of a series of financial crises at the end of the nineties, which affected several developing countries in East Asia, Russia, Brazil and Argentina. On the whole, FDI seems to guarantee more stability compared with other forms of investment and, therefore, fewer possibilities of capital flight. In general, unlike portfolio investment, it is used productively. However, in spite of FDI's apparent good side compared with other financial flows and as occurs with commercial activity and remittances, certain conditions have to be met so that direct investment effectively contributes to more socio-economic development as it is understood in the Millennium Development Goals.

#### *1.3.1. Attraction of FDI*

Firstly, as García points out, so that a developing country can attract a significant volume of FDI, certain conditions have to be met:

- **Competitiveness**  
Competitiveness can come from different sources, such as low labour costs – which are usually an attractive element for intensive investments in manpower– or the efficiency of one or several production factors.
- **Existence of markets**  
Sometimes there is a large consumer market as the pull factor for FDI. One example on the rise is the Chinese market.
- **Institutional features**  
Attractive institutional elements for foreign investors are also important for attracting FDI. This is the case, for example, of legal security or a certain amount of trade liberalisation.

Broadly speaking, it could be said that what a country needs to be capable of attracting direct investment is, actually, a minimum absorption capacity. This would explain the high concentration of direct investment in a few developing countries which furthermore are, in general, emerging economies. It would also indicate that a virtuous circle can be generated in which some minimum development levels can attract direct investment. This, in turn, can promote higher levels of development. It is worth highlighting that some pull factors will have more impact than others on the development FDI is able to encourage. Therefore, for instance, attracting FDI on the basis of a highly qualified workforce will attract investment with more possibilities of contributing to the MDGs than, for example, lax regulations in environmental concerns, which ultimately make it difficult to implement the seventh goal.

#### *1.3.2. FDI and Implementing the MDGs*

Very briefly, it seems that FDI can contribute to implementing the MDGs in six different ways. As with other financial flows, these mechanisms are all subject to different

circumstances, which both the companies promoting the investment and the Administrations in the countries of origin and destination of the investment are responsible for. In certain instances, FDI can also end up being counterproductive to attaining the Millennium Development Goals, just as other financial flows can be. All these mechanisms are described below.

First, direct investment can contribute to increasing total factor productivity, which should lead to more economic growth. Direct investment needs to have the following effects for this to happen:

- Increase in competition in the destination market by means of an increase in efficient production or technological changes, for example.
- Structural change in the country receiving the investment.
- Technological spillovers by means of subcontracts with local industry, training actions, development and manufacture of new products for the local market or the creation of joint ventures. As García points out, for technological spillovers to be generated by any of these means, the receiving country also has to have a minimal absorption capacity of new technologies (remember that this absorption capacity is also a determining factor for attracting FDI) and/or that the attraction of FDI is part of a more extensive national development strategy.

FDI can also lead to an increase in exports and to a more even balance of payments, thus also contributing to economic growth. Nevertheless, the following circumstances are necessary:

- Investment inflows should have a bias towards exports which, even if accompanied by a rise in imports (capital goods, for example) and/or debt inflows in the country (such as financing the parent company), should not be totally offset by it.
- Direct investment will not contribute to development if it generates an appreciation of the exchange rate with the consequences this has on foreign trade integration.

Thirdly, direct investment can have an impact on growth by increasing gross fixed capital formation (GFCF), although to do so it must be greenfield investment and not be the result of a merger and/or take-over process. Similarly, there needs to be a crowding-in effect, which helps to increase the country's economic activity, but without the local companies operating in the sector where the FDI is received being crowded out.

These two conditions are also necessary for direct investment to generate employment in the country of destination. In addition, foreign investment also has to be labour intensive and connections with the local industry must be established, as occurs with technological spillovers.

The effect on salaries that foreign investment might have is connected with employment. This will only occur if the investment meets minimum employment standards, which include relatively high salaries.

A last means of transferring growth and development via FDI is the contribution to the developing country of cleaner technologies, with the condition that the receiving country has a minimum absorption capacity. The latter, as we have already said, is also needed to attract investment and for it to contribute to total factor productivity.

We have already seen that foreign trade integration has to have certain characteristics so that, besides promoting economic growth, it can lead to higher levels of social and economic development. Something similar can happen with FDI. The conditions needed for direct investment to generate development beyond growth are, to a large extent, connected with the receiving country's characteristics and with the existence of a comprehensive development strategy, which is the responsibility of the authorities in the country receiving the investment. But other conditions depend on the nature of the direct investment. Because for FDI to be able to contribute to the Millennium Development Goals –in other words, for it to be capable of reducing the different aspects of poverty– the investment will have to make use of production factors that the poorer segments of the population can acquire (employment, land in some cases) and which is concentrated on sectors in which these same segments can participate.

### *1.3.3. Risks of FDI*

As with other economic flows, the effects of the investment could be counterproductive in certain circumstances. Some of the ways in which FDI can be an obstacle to higher levels of growth and development are:

- Inflows of foreign capital can cause anti-competitive situations if there is an excessive imbalance of capacities between foreign and national companies. This effect would block the possible impact of FDI on economic growth, by means of the increase in total factor productivity and GFCF and it could lead to a fall in economic activity.
- The result is the same if the investment, instead of being greenfield, comes from mergers and take-overs, which is usual in financial liberalisation processes and in the privatisation of public corporations.
- For the same reasons, the crowding out effect could cause an increase in unemployment in the country receiving the direct investment.
- As García points out, there have also been cases in which massive inflows of direct investment have led to local currency appreciation and the deterioration of the current account.
- In the competition to attract foreign capital, some developing countries use competitive advantages that end up reducing growth and/or development possibilities. The so-called 'race to the bottom' phenomena usually occur in employment issues –meagre salaries, sometimes subhuman employment conditions– or in environmental issues –which directly contravene the implementation of the seventh goal–.

### *1.3.4. The Donors' Role*

Briefly, the role of donors in this area is to support not only the conditions developing countries need to attract FDI, but also conditions that will help FDI to transform into higher levels of development. This means, on the one hand, guaranteeing (and not hindering) the production and strategic foreign financial integration of developing countries and, on the other, making contributions within one's possibilities that lead to the conditions required to facilitate transfer mechanisms from direct investment inflows to economic and social development.

Strategic foreign integration as regards direct investment requires developing countries to have a policy space to design and put into practice their own development strategies, in a

similar way to what occurs with strategic trade integration. These strategies can involve the country receiving the investment having a selective attitude towards direct investment inflows. In this way, they can include parallel protection mechanisms for certain local industries –by means of subsidies, for instance– on the one hand, and, on the other, incentives to attract investment in certain sectors that are to be strengthened by foreign capital inflows –using, for example, tax incentives or an improvement in infrastructures–.<sup>6</sup>

Therefore, maintaining this scope for manoeuvre is inconsistent with an international regime –or with regional and bilateral agreements– which aims to standardise regulations concerning direct investment towards the full liberalisation of this kind of flow. Furthermore, donors should perhaps even transcend the more restrictive view of coherence –in which measures counterproductive to the development of poor countries are eliminated– and take a risk with international regulation proposals that ensure a more direct impact of direct investment on the development of aid-receiving countries. In this respect, García suggests introducing provisions –within the international regulatory framework for direct investment– conditional on the behaviour of transnational companies.

Secondly, donors can provide the conditions needed for there to be mechanisms that lead from direct investment to development. These actions can be established both through international cooperation programmes in developing countries and the support –by way of subsidies– of the international expansion plans to developing countries of companies that meet certain requirements.

#### **1.4. External Debt, Restructuring and Cancellation**

External debt, similarly to remittances and FDI, allows a country to offset its internal savings deficit and thus finance growth and development processes that may otherwise not be possible. For debt to lead to more growth it must be kept at sustainable levels and must not generate a process or state of over-borrowing.

At the same time, the elements that have an impact on the level of a developing country's over-borrowing are, on the one hand, connected with IFA –specifically with certain operating mechanisms and the behaviour of agents in the international financial markets (aversion to or propensity towards risk or herd behaviour, for example),– and, on the other, with the developing country's financial characteristics –which include the sequence and rhythm of financial liberalisation, regulation and bank supervision and the development of the local debt market–.

The main international agreements covering the coherence of economic policies for development emphasise that the external debt of aid-receiving countries must be addressed (see the Monterrey Consensus and the eighth Millennium Development Goal). The emphasis on solving the debt problem is justified by the effects that it might generate on the developing countries themselves.

On the one hand, external debt is a burden that drains public and private resources from other sectors that are essential to the country's development, such as education and health.

On the other hand, if borrowing becomes excessive, the drain on resources will be even greater and have a more pronounced effect on development possibilities. In addition, as Carrera and De Diego point out, the state of over-borrowing may be a disincentive to

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<sup>6</sup> This is precisely the type of foreign production integration followed by the majority of developing countries that have achieved certain economic and social welfare levels since the Second World War. This is the case of South Korea, Taiwan and China (Bustelo *et al.*, 2004).

implementing the economic reforms necessary to activate economic growth and a development process. This is because the benefits derived from reform would be exported to the creditor countries via the payment of debt. Smaller incentives generate a fall in investment in the country –both domestic and foreign–, reducing the possibilities for economic growth and therefore also development. Similarly, the weight of the external debt usually limits the developing country's access to other private capital. However, in addition, as occurred in several countries at the end of the nineties and the beginning of this decade, over-borrowing can become a financial crisis if there is a change in the expectations of private agents (Olivié, 2005).

As far as external debt is concerned, the coherence of donors with the development objective should consist, first, of promoting the measures required to prevent debt flows – owing to their volume and/or due date and denomination– leading to economic problems that ultimately have a negative effect on the economic situation. Secondly, donors must also establish or support the initiatives required to solve the external debt problem after it has occurred. Specifically, the following would be required:

- Improving the mechanisms conducive to solving the external debt problem, which should include proposals for a more balanced distribution of the costs of default and initiatives for restructuring and cancellation.
- Supporting domestic measures implemented by developing countries which encourage prudent foreign borrowing and the responsible use of debt.
- As far as possible, establishing measures to prevent the encouragement of risky international financial behaviour by international investors.<sup>7</sup>

With regards to support for national external borrowing control measures, a possibility for donors is to offer technical assistance from their central banks to the developing countries' financial authorities. The financial system plays a key role in external borrowing. Generally, it is this sector that borrows and then channels the financing into the country.<sup>8</sup> As we have already seen, risks are not only inherent in the amount borrowed, but also as regards its term –generally short– and its currency denomination. One way of mitigating these risks is to establish incentives so that they can be adequately managed by the central banks. However, yet again, international commitments to sector distribution of development aid have to be taken into account when considering such a proposal.

External debt management, particularly restructuring initiatives, and, above all, cancellation initiatives, have been debated intensely since the debt crisis erupted in Latin America in the eighties. As Carrera and De Diego state, the main issues to be resolved in the current state of multilateral debt solution mechanisms would be, on the one hand, how to achieve a more balanced distribution of the costs of default and, on the other, how to relieve the external debt burden more effectively for developing countries, whether by restructuring or by cancellation initiatives. Improvement in these two areas mainly affects the following initiatives:

- Paris Club. According to Atienza, the Club's main deficiency is the fact that disputes between the parties –debtors and creditors– are solved following the

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<sup>7</sup> Using the classification established for this paper, this set of measures is applicable to the new international financial architecture (NIFA), which is analysed below.

<sup>8</sup> We should bear in mind, nevertheless, that there are cases in which the borrowing depends directly on national companies, outside the control of the central bank. This happened in South Korea in the years leading up to the 1997 crisis, the period when the *chaebols* looked directly for finance from international banks and issued bonds (Olivié, 2005). These situations are, however, not very frequent in most developing countries.

criteria of only one party, the creditors. In addition, its decisions cannot be appealed against in the courts and the debtor country has to have a current agreement with the IMF in order to enter into negotiations.<sup>9</sup> Nevertheless, as Carrera and De Diego state, we have to take into account that the decisions taken in this forum only affect public debt, which is decreasing in comparison with private debt in the current flows to developing countries.

- The HIPC (Heavily Indebted Poor Countries) initiative, whose main advantage with regards to the Paris Club is that it groups together all the creditors (bilateral, multilateral and trade). Criticism of the HIPC initiative has been multiple and from many different areas. Steps have been taken to reduce the deficiencies in the programme, such as the very small number of beneficiary countries –although average-income countries with serious borrowing problems are still excluded from the initiative– or the volume of cancelled debt, particularly as a result of the G8 meeting at Gleneagles in July 2005 –although the details of the full cancellation are still to be specified–. Therefore, both in these two areas and in the process's conditionality or slowness, the programme still requires progress to provide a more effective solution to the problem of developing countries' external debt.<sup>10</sup>
- A more balanced distribution of the costs of default. Besides the need to improve cancellation and renegotiation mechanisms, there has to be a greater willingness to share out the cost of a possible default among creditors and debtors in a more balanced manner. This idea gave rise to the ill-fated SDRM (Sovereign Debt Restructuring Mechanism), an IMF initiative which was rejected by the US Treasury. In short, as Atienza says, legal security in international debt contracts needs to be improved.

Carrera and De Diego and Delgado insist on the advantages of multilateral mechanisms to solve the external debt problem compared with bilateral options, since multilateral solutions ensure that all the creditors will be treated similarly to a greater extent than bilateral ones.

### **1.5. International Financial Architecture and Aid-Receiving Countries**

There is no single widely-accepted definition of the NIFA. It can be defined as a set of international measures aimed at reducing international financial instability and preventing and managing financial crises with a view to securing and increasing economic growth worldwide, as Bustelo maintains. But it could also encompass measures aimed at achieving the efficiency and stability of the international financial system, which, according to Fernández de Lis and Isbell, should be the NIFA's two main priorities. In any event, there are mechanisms by which IFA has an influence on the development of aid-receiving countries and which, therefore, turn it into an element to be considered in the analysis of the coherence of the economic policies of developing countries with their partners. If we restrict ourselves to a narrower definition of IFA, its impact on development will simply be more indirect.

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<sup>9</sup> Criticism in this respect is usually focused on the conditionality of the aid imposed by the international organisation (see the recommendations section later in the document). This criticism is connected more with conditionality in certain areas of economic policy (which have not always turned out to be the most suitable for the countries affected and which, in any case, have a negative effect on policy space) than with other aspects of conditionality, which are considered to be clearly positive from other viewpoints, such as controlling the use of aid for corrupt practices or the obligation to invest it in key sectors for the welfare of large groups of the population.

<sup>10</sup> For more details on the limits of the HIPC initiative, see the text by Carrera and De Diego.



Following the reasoning expounded by Bustelo, the NIFA would be relevant for this analysis to the extent in which it determines the volume, nature and frequency of foreign capital inflows and outflows in developing countries. Therefore, on the one hand, as it is a determining element of international financial stability, IFA also has an influence on international capital flows, thus acting as a push factor of financial flows for developing countries, which are included in this study. On the other hand, and as a consequence of the same international financial stability, IFA also has an impact on solving and possibly also sowing the seeds of –and triggering– financial crises in developing countries. In this respect, it affects emigrants' money transfers, as they have a counter-cyclical component. IFA also has an influence, in the second instance, on developing countries' external debt, as this usually increases rapidly after a financial crisis due to several factors, such as local currency depreciation –which makes an external debt that is generally in a foreign currency more expensive– or additional borrowing with multilateral organisations due to redemption programmes, among others.

In Bustelo's analysis of IFA, he highlights that the progress made so far –mostly since the end of the nineties as a result of the Asian crises– has been unequal. The main challenges that IFA has to face to contribute to, and not to diminish, the development of aid-receiving countries are as follows:

- Improvement and coordination of the macroeconomic policies of the main developed countries. According to Bustelo, the main challenge in this area would be to achieve a greater coordination of the exchange rate policies of the main currencies and of the monetary policies of the US, the EU and Japan. An important obstacle that needs to be overcome in this area is the lack of synchrony of cycles among the G3 economies.
- Improvement in the dissemination of information on developing countries' financial systems and on some of the macroeconomic and financial rules and regulatory codes used in these countries.
- With regards to the regulation and control of international capital flows, reference must be made to the controversial review of the Basel Agreement. On the other hand, Bustelo points out that there have been no studies of proposals to control portfolio investments and derivative products, which are potentially destabilising for developing economies.
- Another of the great challenges facing the NIFA is an adequate supply of liquidity in the event of a financial crisis. The need to improve the provision of liquidity poses several challenges in the following areas: the creation of an institution or mechanism to facilitate the supply of emergency liquidity, an International Lender of Last Resort (ILLR);<sup>11</sup> a cooperation agreement between central banks, such as the Chiang Mai initiative; the issue of SDRs (Special Drawing Rights), which would solve the problem of the politicisation of contributions based on loan repayment amounts and agreements which respect the IMF voting structure; and, lastly, the IMF's lending capacity.<sup>12</sup>

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<sup>11</sup> According to Fernández de Lis, the term is used somewhat ambiguously. Actually, it is doubtful whether an ILLR, with functions similar to those of a central bank, would be strictly necessary and feasible. Understood as the supply of liquidity in emergency situations, it is a basic function of the IMF, which perhaps the latter does not have sufficient mechanisms for (Díaz, Fernández and Fernández de Lis, 2006).

<sup>12</sup> In recent years, different instruments have been proposed and even created for increasing the institution's lending capacity. Bustelo highlights the SRF (Supplemental Reserve Facility), the CFF (Compensatory Financing Facility), the PRGF (Poverty Reduction and Growth Facility) and the CCL (Contingent Credit Lines), although the latter, a form of preventive credit, have never been used and expired in 2003. Proposals to

- In order to generate a NIFA that really fosters a greater and better integration of developing countries in the international financial circuits, they will have to have a greater say in defining the architecture.

## 1.6. How to achieve Policy Coherence. Institutional Problems

This section is an analysis of the ways in which international economic flows can contribute to the development of aid-receiving countries and of some of the conditions needed for this impact to be positive. In short, what has been analysed so far is the 'what' of economic policy coherence for development. An equally relevant dimension is the 'how' of policy coherence, as without this aspect it would not be possible to offer the Spanish government a set of recommendations.

### 1.6.1. Spain: The Central Role of the State

As there is no international development regime, national governments are ultimately responsible for international (in)coherencies and national policies, which may affect developing countries (Stokke, 2003). Nationally, even in decentralised political systems, responsibility for ensuring policy coherence generally lies with central levels of the Public Administration.

In Spain's case, with a decentralised power system, responsibility for the definition and management of its international cooperation policy lies with the government, through the Ministry for Foreign Affairs and Cooperation (MAEC).

Naturally, and according to current Spanish legislation, a series of consultative and coordinating bodies have been created: the Development Cooperation Council, which brings together the *Administración General del Estado* (AGE –State General Administration–), NGOs and other social agents and experts, the Interterritorial Committee for Development Cooperation (AGE –Autonomous Communities and local entities–) and the Interministerial Committee for International Cooperation (ministers).

### 1.6.2. Institutional Obstacles

Policy coherence for development, besides being an objective, is a process in constant creation. That is why it is fundamental to review and adapt institutions and their operating frameworks to current development commitments. It is extremely difficult for States to be able to comply with their responsibilities in development with institutional structures that have not been created for that purpose and which therefore have neither the means nor sufficient resources. That is why emphasis is being placed on more institutional and transversal aspects of policy coherence (OECD, 2005).

Of the different reasons for development policy incoherence that have been identified so far and described in previous sections, some are mainly institutional and must therefore be tackled from this perspective to try to eliminate them or, at least, to minimise their negative effects. Some of these institutional obstacles are, among others:

- Deficiencies when establishing government action priorities in terms of development in all its spheres of responsibility, and not just in the bodies connected with international cooperation.
- An Inappropriate policy coordination structure.

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create an *ex-ante* insurance for self-fulfilling financial crises or an emergency financing facility or to review the conditional nature of IMF loans aim to rectify existing instruments' deficiencies.

- Deficiencies in obtaining, processing and analysing information, by nature incomplete, on the effects of the different policies on third world development.
- A strict and not very flexible administrative culture.

### *1.6.3. Good Institutional Practices*

As far as the solutions to these challenges are concerned, there cannot be just one answer or just one institutional framework. The OECD, on the basis of the collection and analysis of different initiatives established by its members, emphasises that there is not just one formula to follow to overcome institutional obstacles that prevent reaching higher levels of coherence. However, certain lessons on the institutional innovations of donor countries to promote and facilitate progress in development policy coherence can be extracted from these experiences.

Furthermore, more recently, the OECD published a report that contains a series of good practices in the institutional area.<sup>13</sup> These practices, according to the organisation, cannot be promoted as recommendations or better practices, as they are at a very early phase of their implementation and their results cannot be considered definitive. However, they could serve as a guide after being adapted to each country's circumstances (OECD, 2005).

- Improvement in the definition and focus of policy coherence for development.
- Political leadership and support from public opinion, which are necessary to overcome the challenges involved in attaining policy coherence for development.
- Building capacities in the policy-making process.
- Building capacities that can correctly assess the results of efforts made in policy coherence.

However, the focus promoted by the OECD has its limitations. It does not seem to sufficiently incorporate internal and bureaucratic reluctance towards institutional reform and change, above all if traditional interests in local sectors with more influence in national politics –such as trade or agriculture– have to become subordinate to a more general, abstract objective without, apparently, direct national and long-term beneficiaries, such as development. On the other hand, an essentially institutional and administrative management perspective does not adequately reflect the entire political stage involving different actors, who have an influence on government decisions, such as political parties with different ideological bases, parliament, NGOs and other decentralised governmental institutions that can promote or prevent more policy coherence, depending on the context (Ashoff, 2005).

### *1.6.4. International Implications*

Among the challenges that policy coherence has to face is a complex web of organisations, international and regional forums that have an influence on the development of poor countries. Therefore, Public Administrations must ensure that the array of policies connected with development, divided among ministries and other departments, are coherent with development in the different international organisations of which donor countries are members.

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<sup>13</sup> A previous study by PUMA (1996) also contains some institutional tools needed for more policy coherence.

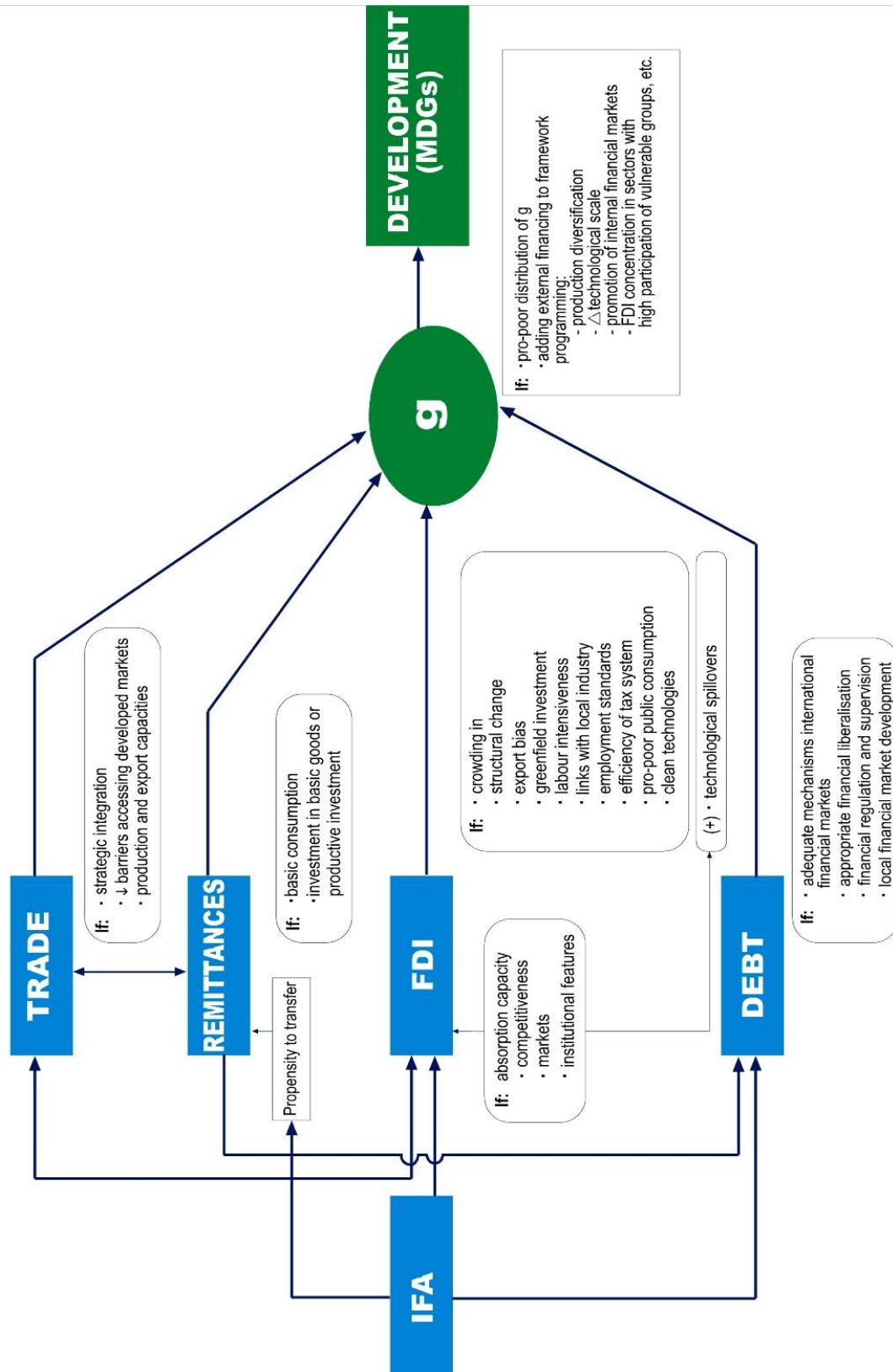
Specifically, many policies that can have –and have– the most impact on the development of the poorest countries are implemented in the European area. At the same time, maintaining a(n) (in)coherent stance with the MDGs in the multiple international economic forums in which an OECD member country participates is a demonstration of the level of efficiency of a suitable institutional framework for policy coherence for development.

#### *1.6.5. Global Economic Governability for Development*

It is widely recognised that the development of poor countries is not feasible without an architecture and international economic institutions that actively promote the MDGs. The reform of the existing international economic institutions, created in a radically different context to the one we have now, is essential to achieve policy coherence for development (Pomfret, 2005).

Countries with a high income are in a crucial moment in their commitment to development. Adopting a view coherent with the MDGs requires a clear intention to promote international institutional reform which incorporates the needs and opinions of developing countries, without this meaning that developed countries stop having a predominant role. There has to be a balance between those that want to maintain a status quo, which has led to welfare in many sectors of the population in developed countries, and those that promote unfeasible reforms in the current political context.

## Potential of foreign trade and financial relations for developing countries



## 2. RECOMMENDATIONS

### 2.1. Trade Policy

#### *R.1. Reform of the CAP: Compensation Fund for Developing Countries Importing Food and Support Programme for European Rural Area*

As is well known, Spanish trade policy is structured by the EU. Promoting greater access to the Spanish market of agricultural export products from developing countries necessarily involves a more ambitious reform of the CAP. This should go beyond eliminating export subsidies and should deal with and consolidate the commitments acquired to get rid of tariffs, import quotas and income aid.

Although it is true that EU trade policy is the result of the opinions of each of its member States, for Spanish trade policy to be coherent with the objectives established in international development cooperation, a reform of the CAP would have to be promoted in European institutions.

CAP reform proposals could focus on the following aspects. First, and with regard to export subsidies, although the EU has already undertaken to withdraw them in 2013, Spain could advocate bringing this date forward to its European partners. On the one hand, as has already been mentioned in several studies, it is one of the most distorting instruments for developing countries' agricultural production and exports and, on the other, Spain is one of the European countries that benefit the least from this kind of support. Secondly, to attain more CAP coherence with the development objective of both the EU and Spain, a reform of income aid is necessary. This instrument, a substitute for production subsidies, now no longer promotes higher production levels in the European countryside, unlike the latter. Nevertheless, aid allocation criteria have not varied very much, thus preserving the instrument's regressive component. Indeed, historical agricultural production (over the last three years) has been the eligibility criterion for granting income aid, so the funds are still concentrated on the largest farms. In addition, and bearing in mind that Europe's agricultural sector –and also Spain's– would be affected by an in-depth reform of the CAP, it would be a good idea to explore alternatives to aid that are less connected with farming, production and/or export and more focused on the conservation of rural areas. It is also worth remembering the diminishing impact of the agricultural and livestock sector on the Spanish economy as a whole.

Another sector that would suffer the costs of a potential transformation of the CAP is that of developing countries that are net food importers, as their imports would become more expensive. Reform of the CAP needs to be accompanied by a compensation fund managed, for example, by European cooperation, in other words the Directorate-General for Development (DG DEV), to guard against any possible situations of food insecurity of certain countries receiving Spanish and/or European aid.

#### *R.2. Progress in the Reduction of Tariffs*

Broadly speaking, progress needs to be made in reducing tariffs in different sectors that particularly affect developing countries' production and export structures, besides agricultural tariffs within the CAP framework. The tariff decrease schedule should also consider the very different export patterns of developing countries, making the requirements of countries with lower levels of economic and social welfare a priority. As would occur with a broader CAP reform, the complete removal of tariff barriers would lead to greater benefits for the more competitive developing countries with higher productivity rates.

Apart from eliminating peak tariffs on manufactured products, mode 4 of the GATS potentially offers enormous benefits for developing countries.

Although migratory pressures can largely explain the opposition of developed countries to further progress in this respect, Spanish immigration laws already regulate the temporary provision of services by foreigners. In this respect, the defence of mode 4 by the Spanish government would be coherent with current national regulations.

### *R.3. Respect for Rules Agreed in Multilateral Forums*

The manufactured goods trade from developing countries is particularly affected by abuse of the anti-dumping clause by developed countries. In more general terms, non-compliance with multilateral trade liberalisation rules can sometimes be detected. A good example is what has happened with the Agreement on Textiles and Clothing since the beginning of 2005.

In general, greater export possibilities for developing countries require more respect for multilateral rules by all the member countries –the WTO's in this case–.

Although Spain has managed to benefit in the short term from recourse to the anti-dumping clause and other protectionist measures by the European authorities, we should bear in mind that, in the medium and long term, it is the credibility of multilateral organisations which is called into question. In this specific case, the WTO's credibility is particularly relevant for developed countries, such as Spain, since it is an outstanding key for accessing extensive markets immersed in very dynamic development processes, such as China.

A possible response to this problem is speeding up the proceedings in disputes within the WTO framework. This could be studied and proposed by the Spanish Administration's representatives in the organisation.

Furthermore, a greater accountability regarding the Spanish government's position on foreign trade in various international forums could have a positive impact –especially in terms of transparency– on both Parliament and public opinion in general.

## **2.2. Recommendations Concerning Emigrant Remittances**

### *R.4. Improvement in Money Transfer Information and Use at Destination*

The Spanish Administration and, specifically, the Bank of Spain can help to improve the information on money transfers (volume, frequency and destination). We would like to stress, however, that unlike other European countries issuing remittances, the information collected by the Bank of Spain is of high quality. For example, data are collected about remittances sent from money transfer companies, which means that a more precise map of these transfers can be constructed. The main challenges in this area have been summarised in a recent study by the IMF (2005).

### *R.5. Reduction in Transfer Costs*

With a flexible approach and by adapting banking rules to the particular characteristics of this flow, money transfers can be made more formal and, foreseeably, in the long term, cheaper. In this respect, we recommend measures to encourage competition, for which it is essential to improve the information available and provide more access to formal transfer channels to irregular immigrants, in a similar way to the measures undertaken in the US.

## **2.3. Possibilities for Action by the Spanish Administration Concerning FDI**

### *R.6. Provisions within Direct Investment International Regulatory Frameworks*

Beyond the need to reserve a policy space for developing countries within international regulatory frameworks, a more ambitious proposal for more policy coherence consists of establishing behaviour provisions for transnational companies within international regulatory frameworks. In fact, this type of provisions, particularly in environmental issues, is already incorporated into the majority of bilateral and regional investment agreements.

### *R.7. Support for Direct Investment by Spanish Companies Subject to Development Criteria at Destination*

Support mechanisms for a company's internationalisation will be more effective to encourage expansion abroad of small- and medium-sized companies than of large ones, and, therefore, by means of a system of incentives, so will the nature of the investments that are destined for developing countries. Some examples are the FIEEX (*Fondos de Inversión en el Exterior* –Foreign Investment Funds–) and FONPYME (*Fondo de Inversión para la Pequeña y Mediana Empresa* –Investment Fund for SMEs–), since they include codes of conduct, especially environmental ones, for the companies benefiting from the programmes. Other support instruments are those managed by the ICO (*Instituto de Crédito Oficial* –Spanish Official Credit Institute–) and the Spanish Credit for Export Company, CESCE (*Compañía Española de Crédito a la Exportación*).

Given the conditions required for FDI to start up growth and development processes at destination, these instruments could consider the types of investment Spanish companies make in order to promote subcontracting with local companies at destination, the creation of joint ventures with local partners, training activities, developing new products for the local market, promoting exports (which is not completely compensated by an import bias or with an impact on external borrowing), greenfield investments and, in any event, observance of some minimum employment and environmental standards.

In addition, the Administration can help SMEs to reduce transaction costs, particularly those derived from information asymmetry, which are generated in internationalisation strategies. Indeed, unlike large companies, SMEs do not have the necessary analysis tools, their own analysis units or resources to acquire these analyses. As a result, perhaps the possibility of increasing the resources available for already existing initiatives should be considered as guidelines for investment.

Support by the Administration has the added incentive for transnational companies of the fact that they benefit hugely from observance of some of the conditions necessary for FDI to contribute effectively to development. This especially refers to establishing connections with the local industry. As far as SMEs are concerned, this type of cooperation can be essential for entry into new markets, and, in the case of large companies, it contributes to improving the image or maintaining a positive image of companies that operate in important sectors, such as basic infrastructures (water and energy). Ultimately, the transnational company's image is connected with the investment's stability.

## **2.4. Measures for the External Debt of Aid-Receiving Countries**

### *R.8. More Effective Relief from the Burden of External Debt via the Paris Club and the HIPC Initiative*

The Spanish Administration's main task consists of speeding up, via its participation in multilateral forums, the procedures required for aid-receiving countries to be able to



access relief for their external debt in the Paris Club and the HIPC initiative quickly and effectively.

Specifically, the main issues to be solved are the slowness of the procedures, the small number of developing countries benefiting from the HIPC programme (particularly highly-indebted average-income countries), the conditionality and discretionary nature of debt cancellation and the insufficient volume of cancelled debt.

#### *R.9. Legal Security in International Debt Contracts*

Mechanisms such as the SDRM, promoted by the IMF, would allow for a more balanced distribution among creditors and debtors of the cost of developing countries' defaulting on their external debt. In this regard, the Spanish representatives at international financial institutions (mainly from the Ministry of the Economy) and the Administration's bodies with a certain amount of influence in these organisations (such as the Bank of Spain, whether directly or through the European Central Bank) could consider the possibilities of reactivating a proposal of this kind. It is actually a case of establishing omnicomprehensive mechanisms to solve the external debt problem of developing countries. These mechanisms must be aimed at providing a definitive solution to the debt problem.

### **2.5. International Financial Architecture and Development**

#### *R.10. Review of Some Rules and Codes of Good Practices (Information Dissemination and Analysis Mechanisms on the State of Financial Systems and Macroeconomic Regulation and Financial Rules in Developing Countries)*

Besides the need to preserve a policy space in this area as well, there are doubts about the usefulness of information dissemination and analysis mechanisms (Special Data Dissemination Standards, General Data Dissemination System) in the prevention of financial crises. There are also doubts about whether the rules and codes include sufficient anticyclical provisions.

With regards to the above, a task the Spanish Administration could consider is whether these mechanisms, rules and codes need to be reviewed and a proposal put forward to the IMF and other organisations and international forums.

#### *R.11. Review of Basel II for Developing Countries*

Although its objective is not the channelling of financing towards aid-receiving countries, Basel II rules could, however, lead to a greater concentration on international financing, excluding an even larger part of these countries from the latter, which goes against the objectives set by the international community regarding development.

An alternative would have to be considered to prevent this effect on available financing for developing countries. This alternative would try to reconcile appropriate risk management without encouraging procyclical behaviour in the financial markets. Spanish views on this matter are put forward before the Bank for International Settlements in Basel.

#### *R.12. More Efforts in Obligations to Disseminate Information by Certain International Financial Agents*

Some of the private companies operating in the financial markets, such as highly-leveraged institutions (especially hedge funds), have played an important role in triggering financial crises in the emerging economies. More dissemination of information could

contribute to preventing these crises. Despite the technical problems that this type of measures probably imply, the Administration may find this proposal useful.

## **2.6. International Development Cooperation Policy**

### *2.6.1. Technical Assistance for Strategic Foreign Integration*

One of the deficiencies that has been repeatedly made evident in this document is the fact that developing countries do not have enough capacity to develop appropriate measures for foreign economic integration, whether in the trade or financial areas. Nevertheless, when suggesting different technical assistance possibilities for a more strategic foreign integration, the international commitments in force which affect the sectoral distribution of aid have to be taken into account, such as the 20/20 commitment already mentioned.<sup>14</sup>

### *R.13. Production and Trade Capacities*

This area includes the contributions made by the *Ministerio de Industria, Turismo y Comercio* (Ministry of Industry, Tourism and Trade) to the trust fund of the WTO and the UNCTAD (*United Nations Conference on Trade and Development*).

### *R.14. Development of the Local Financial System*

We recommend providing greater access to banking services, which helps remittances to be used for production investments, and specifically encouraging bank usage by migrants' families and offering them a wider variety of financial products. In this area, we also recommend a wider geographical presence of formal financial institutions in the developing countries, whether directly or indirectly via microcredit entities.

### *R.15. Technical Assistance for External Debt Issues*

The purpose is to prevent situations of over-borrowing, which we have already described. That is why bank regulatory measures are important, established by the financial authorities of the country receiving the foreign capital, which encourage a suitable management of the volume of external borrowing and which balance their due date or their currency denomination. In Spain, technical assistance given to central banks in developing countries is coordinated by the Bank of Spain.

### *R.16. Competitiveness of Production Factors*

Support, by donors, for the development of advanced competitive factors contributes to FDI's pull factors. Proposals could include training programmes that promote more productivity from the workforce, information infrastructures and communications or technical assistance for the implementation of more attractive institutional characteristics for the FDI.

### *R.17. General Support for FDI's Impact Conditions on Development*

Similarly, technical assistance for international production integration can focus on meeting the conditions needed so that direct investment can have a clear impact on growth and development (see R.7).

For technical assistance in attracting and channelling FDI for development, we should

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<sup>14</sup> The commitment of Spanish cooperation to the 20/20 initiative is backed by its plan for 2006 (see MAEC, 2006).

take already existing multilateral and bilateral initiatives into account and consider, if necessary, a review of the programmes on the basis of the conditions –already outlined– of both attraction and consolidation of FDI development.

The WAIPA (World Association of Investment Promotion Agencies), supported by the UNCTAD, should be assessed in this context. It holds forums and seminars in order to train developing countries' FDI managers so that they can define promotional activities. Another example is the MIGA (Multilateral Investment Guarantee Agency), which also provides information and training.

Spanish cooperation also implements this type of programme financed by the AECI (*Agencia Española de Cooperación Internacional* –Spanish International Cooperation Agency–), CECO (*Centro de Estudios Comerciales* –Centre for Commercial Studies–) and ICEX (*Instituto Español de Comercio Exterior* –Spanish Institute for Foreign Trade–), coordinated, on occasion, with the MIGA.

Other programmes that may contribute to the conditions necessary for FDI to lead to development are the programmes specifically aimed at the educational sector on different levels. The quality of the education system has a very direct influence on the receiving country's competitive advantages. Besides, unlike other initiatives proposed in this paper, this type of programme falls within the 20/20 initiative, thus complying with the commitments acquired in sectoral aid distribution.

#### *R.18. Adoption of Rules and Codes of Good Banking and Financial Practices*

These support measures enable the better international financial integration of developing countries. Yet again, this type of assistance falls within the Bank of Spain's sphere of action.

#### *2.6.2. Support Measures in Co-Development*

#### *R.19. Specific Projects for Migrants' Families*

These projects would help to increase the impact on development of the use at destination of emigrants' remittances. Possible actions include training (on rights, obligations and benefits as clients of the banking system), the establishment of support systems and advisory services for production investment.

#### *R.20. Improvement in Statistics on Developing Countries*

Many action proposals for donors are limited by the dearth and poor quality of available data on developing economies. This weakness is particularly obvious with regards to the use at destination of the emigrants' remittances. In this area, Spanish cooperation could contribute to initiatives to improve data internationally –Paris21 for instance– and also in the developing countries themselves.

### **2.7. Respect for Policy Space**

Respect for policy space involves very varied measures in several areas of foreign economic action. Most of them are structured around supranational or multilateral organisations, so policy coherence in this area depends, above all, on the positions held by different bodies of the Spanish Administration.

### *R.21. More Margin for Manoeuvre for Developing Countries in the WTO*

The review of the WTO's 'green room' system, or the extension of developing countries' possibilities of access to special and differentiated treatment, would have a very positive result for aid-receiving countries' development.

### *R.22. Review of Regulations concerning Direct Investment*

In general terms, the fact that there is a policy space for foreign financial integration does not seem to be compatible in principle with national and international regulations tending towards the complete liberalisation of financial flows, including, as is the case, direct investment flows. This marks out the opinions to be defended by the Administration within the WTO on investment agreements: GATS, which restricts imposing access conditions, in other words limits to foreign property, TRIMS (Trade-Related Investment Measures), ASCM (Agreement on Subsidies and Countervailing Measures), which prohibits the use of subsidies for export and local contents, and TRIPS (Trade-Related Aspects of Intellectual Property Rights). This same principle has to guide regional and bilateral investment agreements, which should reflect the characteristics of the different countries.

Specifically, one of the aspects in which precaution with regulatory standardisation is recommended is national treatment. Regulations on foreign investment should consider exceptions to national treatment for foreign companies in order to preserve support instruments for local industry so that development models can be retained. This type of actions, which are already being implemented nationally and in Europe, could be supported internationally as well.

### *R.23. Review of Some Rules and Codes of Good Practices Concerning Macroeconomics and Finance Applied to Developing Countries*

Although considerable progress has been made in the international regulation of the operation of the financial system in developing countries, preserving a margin of manoeuvre for these countries is contrary to an excessive standardisation of some international rules and codes. As they have been tailored to developed financial systems, they sometimes do not consider the particular characteristics of financial systems in developing countries.

### *R.24. More Participation of Developing Countries in the Main International Forums that Define IFA*

The redistribution of quotas and votes in the IMF on the basis of current shares of the world economy, giving, for example, more importance to GDP in the IMF formula, along the lines proposed in the Cooper report, would make it possible to increase the participation of developing countries in a forum to determine IFA and, therefore, also these countries' access to a sufficient and stable international financing. This measure would also increase Spain's current influence in the organisation. Although there are usually complaints about the EU's overexposure in the institution, Spanish participation, however, is much less than it should be if readjusted on the basis of its current influence in the international economy.

As far as other forums are concerned, it would be a good idea for some developing countries to participate in the Financial Stability Forum and G20, in order to make them more representative and sensitive to the former's claims.

*R.25. More Participation from Spain in the International Debate on the Review of the Conditionality of the IMF and the World Bank in its Assistance Programmes*

There is a quite a widespread consensus that the review of conditionality, especially in the IMF, has been insufficient and that it has not managed to remove doubts on the efficiency of economic restructuring and on its eventual interference in legitimate development strategies. The Spanish Administration could be more active in the debate on this question in different forums, including the international financial institutions themselves.

**2.8. Institutional Recommendations**

In the case of Spain, there are some institutional conditions already in place that can facilitate policy coherence for development, such as adding the word Cooperation to the name of the *Ministerio de Asuntos Exteriores* (Ministry of Foreign Affairs), the recent creation of the DGPOLDE (*Dirección General de Planificación y Evaluación de Políticas para el Desarrollo* –the Spanish Directorate-General of Policy Planning and Evaluation for Development–) or the report project of the Policy Coherence Group, which will be taken to the *Comisión de Cooperación Internacional para el Desarrollo* (International Cooperation Committee for Development) of the *Congreso de los Diputados* (the lower house in the Spanish Parliament).

*2.8.1. Theoretical and Empirical Backing*

*R.26. Development and Promotion of Research in Policy Coherence*

We need to improve both definitions and common indicators in the analysis of the impact of incoherencies on developing countries in order to make some progress. This would make it easier to adopt measures to alleviate and counterbalance, if possible, their negative consequences for development. In addition, efforts should also be aimed at establishing measurable coherence goals, thus facilitating the donor community's commitment.

Although more input is required, some steps have already been taken in this area, such as those by the Public Administration, specifically the DGPOLDE, which manages a research aid programme that includes policy coherence. There are initiatives managed through the OECD and also projects by other private centres, such as the CGD (Centre for Global Development), which has implemented a Commitment to Development Index (CDI).

*R.27. Creation of Policy Coherence Networks*

Considering that other countries and institutions have been implementing different initiatives and institutional reforms concerning policy coherence, it would be a good idea to encourage the exchange of experiences and knowledge both at a public level (all the levels and sectors of the national AGE and of the autonomous and local administrations) and a private one (academic institutions, NGOs, etc). We also suggest involving developing countries' institutions and organisations in order to increase knowledge and, consequently, the demands of the recipient countries for policy coherence.

*R.28. Promotion and Improvement of the Dissemination of the Importance of Policy Coherence*

Dissemination of coherence research and experiences could be reinforced by means of seminars, forums and different types of activities, which can be either restricted –if they

are more technical– or more open to raise public awareness of the issue, such as virtual or physical forums. The latter can be used to take advantage of activities with a great deal of media impact (such as, for example, UN Summits) so as to spread awareness of them and have more influence on public opinion.

### *2.8.2. Achievement of a General Consensus for Policy Coherence*

In view of difficulties to increase the impact and influence of development issues and for the entire government and public administrations to adopt them, we recommend that a general consensus for policy coherence is reached.

### *R.29. Preparation of a White Paper for Policy Coherence*

Commitment to policy coherence for development needs to extend further than the current spheres of cooperation policy to the rest of the ministries and departments involved in the measures analysed in this report in order to achieve acceptable levels.

Some members of the Development Assistance Committee (DAC) have opted to incorporate an international cooperation law, action programmes and strategies into their legal system. Spain, which already has Law 23/1998, could establish a consultation process, with participation by all levels and sectors of the public administration and all the actors involved, both public and private. With extensive participation, resistance to change and lack of understanding about this area would decrease.

Similarly, some of the basic parameters to achieve policy coherence should be agreed in the White Paper.

- Establishment of priorities.
- Explicit allocation of areas of responsibility for cooperation and policy coherence to an organisation.
- Currently, the MAEC is responsible for coordinating Spanish cooperation. However, it does not have the same responsibilities as other bodies in policies connected with aid recipients' development.
- Establishment of an acceptable incoherence level.
- It is recognised that democratic political systems imply a certain degree of incoherence, in order to meet the needs and demands of different groups, which in many cases have opposing interests. For incoherencies that are considered inevitable, it would be best to anticipate their negative impacts and establish appropriate compensation mechanisms.
- Establishment of periodic review processes.
- Given the complexity, variety and changing nature of the multiple measures and policies organised by developed countries and which affect aid recipients, review systems and periodic reformulations need to be established for the conceptual framework of international cooperation and policy coherence, as well as for the institutions involved.
- Clarifying specific and measurable objectives, commitments and responsibilities.
- Each Public Administration sector and level has to know what its obligations are in this area so that the developing countries' interests are one of the criteria taken into account in every decision taken in the public administration, which may have a potential impact in this area. We recommend the implementation of target indicators for appropriate assessment of the level of compliance with them.
- Involving parliament more actively.
- Specific question time could be used for policy coherence, which would help to draw people's attention to coherence and it would generate more commitment in

the different political forces. In this respect, the role played by the current *Comisión de Cooperación Internacional para el Desarrollo* of the *Congreso de los Diputados* is important.

- More transparency.
- Although the coordination bodies of development cooperation publish minutes and other documents of their sessions, their dissemination should be extended.

### *2.8.3. Creation of Capacities in the Public Administration*

#### *R.30. The Organisation Responsible for Policy Coherence Must Have Appropriate Personnel and Resources*

Human resources must have the sectoral and general knowledge required to be able to establish and direct dialogue and cooperation with all the ministries and departments involved, as well as to process and analyse all the information needed to influence the decision-making process of other policies.

Bearing in mind the relevance of the issues and policies dealt with in forums and international organisations, especially in Europe, it is essential to reinforce capacities and human and material resources for achieving policy coherence in Spanish delegations and representations in them.

#### *R.31. Improvement in Coordination Mechanisms*

As experience in other countries dictates, there are several mechanisms for improving the coordination of the policy formulation process with an impact on developing countries. The aim is to encourage those responsible for development policy to work together with other areas in order to resolve possible conflicts and to identify synergies that favour development. In some cases, this coordination takes place in cabinet meetings, in the president's or prime minister's office or in another committee or general coordination forum of the government.

These options imply that the person responsible for development policies is represented at the highest level of the government's general coordination. In Spain, this position is held by the Minister for Foreign Affairs and Cooperation. In this case, the analysis and/or debate of specific issues concerning policy coherence could be a routine and obligatory addition to the agenda of cabinet meetings with ministers responsible for other government portfolios and the prime minister. The latter's active and committed role is fundamental.

In addition, initiatives aimed specifically at achieving policy coherence can be created. They enable the government to strengthen their commitment to this issue and give it more media attention.

- Conversations about coherence: regular intersectoral meetings between several ministers to steer trade, agricultural, debt, environmental and security and defence policies towards development.
- Focal points: some countries have created permanent units on policy coherence with responsibilities for coordinating several intersectoral working parties, analysing and managing specific incoherencies as they arise, coordinating the country's views on international, community and regional organisations and forums.

- Several *ad hoc* or permanent committees and meetings: they are usually on specific matters and with varied representation depending on the issue to be dealt with.

In Spain's case, we recommend an exhaustive analysis of the consultation and coordination bodies of cooperation for development from the perspective of policy coherence. Based on this study, a review and consolidation of these organisations might be advisable in order to steer their duties specifically towards achieving policy coherence or even creating another body, bearing in mind other donors' experiences.

#### *R.32. Establishing Monitoring and Assessment Mechanisms Specifically for Policy Coherence*

To do this, some type of progress index in policy coherence would have to be established for Spain, agreed among all the sectors and levels involved, for example in the process of preparing the White Paper. In addition, we also recommend incorporating the perspective (and other specific elements) of policy coherence in the assessment of Spanish cooperation programmes.<sup>15</sup>

#### *2.8.4. Other Institutional Recommendations*

##### *R.33. Analysis of Coherence Outside the Administration*

NGOs and studies on international development cooperation have a role to play in the formation of public opinion regarding the (in)coherencies of donors' policies. We should remember that it is public opinion which is ultimately going to intensify political willingness to solve incoherencies.

##### *R.34. Budgeting for Policy Coherence*

A greater analysis of the problem by these institutions and the Administration would also allow (in)coherencies to be budgeted for in the long-term. Besides providing the organisations with responsibilities in policy coherence with the resources they need, a compensation fund could be set up for those incoherencies that are considered inevitable, in other words, to mitigate the negative effects on developing countries.

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<sup>15</sup> In fact, this is already being incorporated in some assessments, such as Spanish cooperation with Morocco, which includes the following among its objectives: the geographical and sectoral coherence of instruments and actions implemented in the country; the degree of relevance and alignment with the national development policy and its suitability with the objective of Spanish cooperation in poverty reduction; as well as coherence with the Spanish government's other policies.



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